

exercise of the stock option, in addition to the credit to cover the purchase price of the stock.

(b) Section 207.1(h) prohibits a lender governed by Regulation G from extending purpose credit if it is secured by collateral including margin securities, which also secures any other credit to the same person in excess of \$5,000. Unless credit to pay income taxes is also treated as purpose credit, it could not be extended in an amount in excess of \$5,000 when the borrower also has a purpose loan outstanding with the lender, secured by margin securities, since such collateral would be deemed to be also securing the income tax loan. *Purpose credit* is defined in § 207.2(c) of the regulation as credit which is for the purpose, whether immediate, incidental, or ultimate, of purchasing or carrying a margin security."

(c) Section 207.4(a), which provides special treatment for credit extended under employee stock option plans, was designed to encourage their use in recognition of their value in giving an employee a proprietary interest in the business. Taking a position that might discourage the exercise of options because of tax complications would conflict with the purpose of § 207.4(a).

(d) Accordingly, the Board has concluded that the combined loans for the exercise of the option and the payment of the taxes in connection therewith under plans complying with § 207.4(a) may be regarded as credit which is for the purpose of purchasing or carrying a margin security within the meaning of § 207.2(c). Since the combined loans are treated as purpose credit, § 207.1(h) does not prohibit the transaction, irrespective of amount.

[45 FR 44256, July 1, 1980]

§ 207.112 Purchase of debt securities to finance corporate takeovers.

(a) Petitions have been filed with the Board raising questions as to whether the margin requirements in Regulation G apply to two types of corporate acquisitions in which debt securities are issued to finance the acquisition of margin stock of a target company.

(b) In the first situation, the acquiring company, Company A, controls a shell corporation that would make a

tender offer for the stock of Company B, which is margin stock (as defined in § 207.2(i)). The shell corporation has virtually no operations, has no significant business function other than to acquire and hold the stock of Company B, and has substantially no assets other than the margin stock to be acquired. To finance the tender offer, the shell corporation would issue debt securities which, by their terms, would be unsecured. If the tender offer is successful, the shell corporation would seek to merge with Company B. However, the tender offer seeks to acquire fewer shares of Company B than is necessary under state law to effect a *short form* merger with Company B, which could be consummated without the approval of shareholders or the board of directors of Company B.

(c) The purchase of the debt securities issued by the shell corporation to finance the acquisition clearly involves *purpose credit* (as defined in § 207.2(l)). In addition, such debt securities would be purchased only by sophisticated investors in very large minimum denominations, so that the purchasers may be *lenders* for purposes of Regulation G. See 12 CFR 207.2(h). Since the debt securities contain no direct security agreement involving the margin stock, applicability of the lending restrictions of the Regulation turns on whether the arrangement constitutes an extension of credit that is secured indirectly by margin stock.

(d) As the Board has recognized, *indirect security* can encompass a wide variety of arrangements between lenders and borrowers with respect to margin stock collateral that serve to protect the lenders' interest in assuring that a credit is repaid where the lenders do not have a conventional direct security interest in the collateral. See 12 CFR 211.113. However, credit is not indirectly secured by margin stock if the lender in good faith has not relied on the margin stock as collateral extending or maintaining credit. See 12 CFR 207.2(f)(2)(iv).

(e) The Board is of the view that, in the situation described in paragraph (b) of this section, the debt securities would be presumed to be indirectly secured by the margin stock to be acquired by the shell acquisition vehicle.

The staff has previously expressed the view that nominally unsecured credit extended to an investment company, a substantial portion of whose assets consist of margin stock, is indirectly secured by the margin stock. See Federal Reserve Regulatory Service ¶5-917.12. This opinion notes that the investment company has substantially no assets other than margin stock to support indebtedness and thus credit could not be extended to such a company in good faith without reliance on the margin stock as collateral.

(f) The Board believes that this rationale applies to the debt securities issued by the shell corporation described above. At the time the debt securities are issued, the shell corporation has substantially no assets to support the credit other than the margin stock that it has acquired or intends to acquire and has no significant business function other than to hold the stock of the target company in order to facilitate the acquisition. Moreover, it is possible that the shell may hold the margin stock for a significant and indefinite period of time, if defensive measures by the target prevent consummation of the acquisition. Because of the difficulty in predicting the outcome of a contested takeover at the time that credit is committed to the shell corporation, the Board believes that the purchasers of the debt securities could not, in good faith, lend without reliance on the margin stock as collateral. The presumption that the debt securities are indirectly secured by margin stock would not apply if there is specific evidence that lenders could in good faith rely on assets other than margin stock as collateral, such as a guaranty of the debt securities by the shell corporation's parent company or another company that has substantial non-margin stock assets or cash flow. This presumption would also not apply if there is a merger agreement between the acquiring and target companies entered into at the time the commitment is made to purchase the debt securities or in any event before loan funds are advanced. In addition, the presumption would not apply if the obligation of the purchasers of the debt securities to advance funds to the shell corporation is contingent on the shell's

acquisition of the minimum number of shares necessary under applicable state law to effect a merger between the acquiring and target companies without the approval of either the shareholders or directors of the target company. In these two situations where the merger will take place promptly, the Board believes the lenders could reasonably be presumed to be relying on the assets of the target for repayment.

(g) In addition, the Board is of the view that the debt securities described in paragraph (b) of this section are indirectly secured by margin stock because there is a practical restriction on the ability of the shell corporation to dispose of the margin stock of the target company. *Indirectly secured* is defined in § 207.2(f) of the regulation to include any arrangement under which the customer's right or ability to sell, pledge, or otherwise dispose of margin stock owned by the customer is in any way restricted while the credit remains outstanding. The purchasers of the debt securities issued by a shell corporation to finance a takeover attempt clearly understand that the shell corporation intends to acquire the margin stock of the target company in order to effect the acquisition of that company. This understanding represents a practical restriction on the ability of the shell corporation to dispose of the target's margin stock and to acquire other assets with the proceeds of the credit.

(h) In the second situation, Company C, an operating company with substantial assets or cash flow, seeks to acquire Company D, which is significantly larger than Company C. Company C establishes a shell corporation that together with Company C makes a tender offer for the shares of Company D, which is margin stock. To finance the tender offer, the shell corporation would obtain a bank loan that complies with the margin lending restrictions of Regulation U and Company C would issue debt securities that would not be directly secured by any margin stock. The Board is of the opinion that these debt securities should not be presumed to be indirectly secured by the margin stock of Company D, since, as an operating business, Company C has substantial assets or cash flow without regard to the margin stock of Company

D. Any presumption would not be appropriate because the purchasers of the debt securities may be relying on assets other than margin stock of Company D for repayment of the credit.

[51 FR 1781, Jan. 15, 1986]

§207.113 Application of the single-credit rule to loan participations.

(a) Amendments to parts 207 and 220, effective October 11, 1991, amended §207.3(l) of Regulation G and §221.3(i) of Regulation U of this chapter to permit transfers of loans between different types of lenders. In connection with that rulemaking, comments were received asking the Board to consider the application of the single-credit rule to the purchase of loan participations by lenders and banks who have other outstanding purpose credit with the same borrower.

(b) The single-credit rule (§207.3(g) of Regulation G and §221.3(d) of Regulation U of this chapter), provides in part that “[a]ll purpose credit extended to a customer shall be treated as a single credit, and all the collateral securing such credit shall be considered in determining whether or not the credit complies with this part.” If a lender or bank extends purpose credit to a borrower and then purchases a participation in a loan to the same borrower that represents purpose credit secured by margin stock, the single-credit rule requires the aggregation of the two credits. If the borrower pays off one of the two loans, the participating lender or bank is prohibited under the withdrawal and substitutions provision (§207.3(i) of Regulation G and §221.3(f) of Regulation U of this chapter) from allowing the lead lender or bank to release the pro rata share of the collateral pledged for that participation unless the other loan is secured by collateral with sufficient maximum loan value. In addition, the lead lender or bank cannot allow any withdrawals of collateral during the course of the loan without contacting each participant to check on the status of any unrelated purpose credit to that borrower. These administrative burdens discourage the syndication and transfer of purpose loans.

(c) A version of the single-credit rule was incorporated in Regulation U when

it was first issued in 1936. The rule assumed a direct relationship between the borrower and the bank. The modern practice of syndication or subsequent resale of participations severs the direct relationship between the borrower and the lender and presents difficulties, as described above, in the further administration of the loans for compliance with the margin regulations.

(d) The Board is of the view that as long as the lead lender or bank has control of the collateral, monitors the entire syndicated loan on a stand-alone basis, and does not allow withdrawals or substitutions unless sufficient collateral remains, participating lenders and banks need not aggregate participations with other unrelated purpose credit they have with the borrower under the single-credit rule.

[56 FR 46228, Sept. 11, 1991]

§207.114 Credit to brokers and dealers.

(a) The National Securities Markets Improvement Act of 1996 (Pub. L. 104-290, 110 Stat. 3416) restricts the Board’s margin authority by repealing section 8(a) of the Securities Exchange Act of 1934 (the Exchange Act) and amending section 7 of the Exchange Act (15 U.S.C. 78g) to exclude the borrowing by a member of a national securities exchange or a registered broker or dealer “a substantial portion of whose business consists of transactions with persons other than brokers or dealers” and borrowing by a member of a national securities exchange or a registered broker or dealer to finance its activities as a market maker or an underwriter. Notwithstanding this exclusion, the Board may impose such rules and regulations if it determines they are “necessary or appropriate in the public interest or for the protection of investors.”

(b) The Board’s margin regulations, Regulations G, T and U (12 CFR Parts 207, 220 and 221, respectively), currently contain rules regarding loans to brokers and dealers based on former section 8(a) of the Exchange Act and its interplay with the earlier version of section 7 of the Exchange Act, which instructed the Board to prescribe rules and regulations with respect to the